ZULAUF CONSULTING

INVESTMENT COMMENT

March 16, 2020
VOLUME 29, NUMBER 7

IN THIS ISSUE

POSITION SUMMARY

MARKET	CYCLE	MEDIUM-TERM *Up to 3 months*
S&P	Bearish	Bearish
30y Long Bond (price)	Neutral	Neutral*
Brent Oil	Neutral	Bearish
Gold	Neutral	Bearish*
EUR/USD	Bullish	Bullish
USD/JPY	Bearish	Bearish
USD/CNH	Bullish	Constructive

* Indicates a new position or change in view

HIGHLIGHTS

- The corona virus has become the world's biggest hysteria ever. It is played up by the media and governments to such a degree that it does a lot of damage to the world economy. Domino effects are now running through the system.
- We have not only a health crisis, but also an oil price war on top of it that infected the credit markets. Credit markets infect the corporate sector and the equity market. If it lasts long enough, a potential pension crisis could erupt, as many pension organizations are underfunded and cannot achieve the returns needed to fulfill their liabilities. And the repo crisis may intensify again.
- Authorities are stepping in to intervene, as we expected. Central banks are rightly supplying funds to support ailing corporations, including financial institutions. And fiscal policy stimuli are designed around the world. However, if people stay home due to fear of getting infected, stimuli cannot work and the damage will continue to run through the system.
- So far, a sharp drop has brought many sovereign yields to new historic lows. We believe they are now in our target zone, and that is why we go neutral on them. Our intended next step is to turn bearish on high quality bonds for the cycle sometimes in the first half of this year.
- Bond markets are becoming more discriminating, as perceived risks have been priced in, junk yields have skyrocketed, and quality spreads including those of weak sovereigns have widened sharply. We are glad we have been recommending, for a long while, that our subscribers stay away from the emerging market universe and low-quality investments. We hope this helped you to avoid deep losses.
- It never pays to go for the extra yield late in a cycle. We think that extremes in perceived quality bonds are in the target zone in price now, but perhaps not yet in time. We recommend to hold off buying. Our next step will be a sell recommendation, most likely in the first half of this year.

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- The first short-covering rally in the major currencies like euro, yen and Swiss franc is over. There may be a second attempt to the upside for these currencies before the bull market in the US dollar resumes. The US dollar has remained well supported against EM currencies, and we expect that to continue. We do not share the bearish attitude for the US dollar that prevails in the market.
- The first big liquidation wave in equities is most likely in a terminal stage, as all sorts of risk and fear indicators signal a multi-year extreme on Thursday of last week. But the non-confirmations that are usually seen at a multi-year low are still missing. We expect the next few months to bring volatile sideways trading with potentially lower lows likely that could bring those non-confirmations for a solid medium-term low. However, as the major indices in the US and Europe hit our original target zone in terms of price, we would hold off any short selling here. It's also too risky to go long. We recommend holding cash, until the indicators confirm we've seen a medium-term bottom.
- Our big picture view is explained inside this report, and we stick to our economic forecast that the second half of the year will bring a medium-term recovery, particularly in Q4. It has paid to stick to a defensive stance, and not trying to catch a falling knife. A classic selling climax is still missing but if taken two days together, Thursday/Friday of last week had some but not all necessary earmarks. That is why we prefer to not chase stocks until confirmation arrives.
- In this issue of our Investment Comment, we explain some of the technical indicators we are following and offer you some tactical advice, as this is now more important to follow in this kind of trading environment rather than making a correct long-term forecast.
- Commodities may search for a bottom like bond yields, but it may take time. Crude oil remains weak due to the ongoing price war. We doubt that we have seen the bottom yet, although Saudi Arabia cannot hold out as long as Russia.
- Gold has topped medium-term. We have been afraid of such a reversal for some time. We think a lengthy correction is beginning. According to our stop loss suggestion, our subscribers are out of long gold positions. However, we have a lot of sympathy with a bullish long-term view, as our authorities will be forced to debase the currencies to prevent a systemic collapse, which we assume will be bullish gold in coming years.

Potential Short-Term Low but No Safe Buying, Yet

The major indices like the S&P500 fell into our target zone late last week. Others like the Dow Jones Industrial Average broke the December 2018 low, which was another of our expectations. And European indices fell even more than those in North America. All the momentum indicators, oscillators, volume, and breadth indicators - and the broad arsenal of our fear indicators - showed extreme readings late last week. Those readings were in general more extreme than at the December 2018 low, but not as extreme as at the 2009 low. The headlines ran wild around the world, and the talking heads in the media were completely lost. Political leaders showed up and tried to calm the public and announced precautionary supporting measures.

A classic selling climax (sharply down, sharply up, closing up with large trading volume) was still lacking in last week's lows.

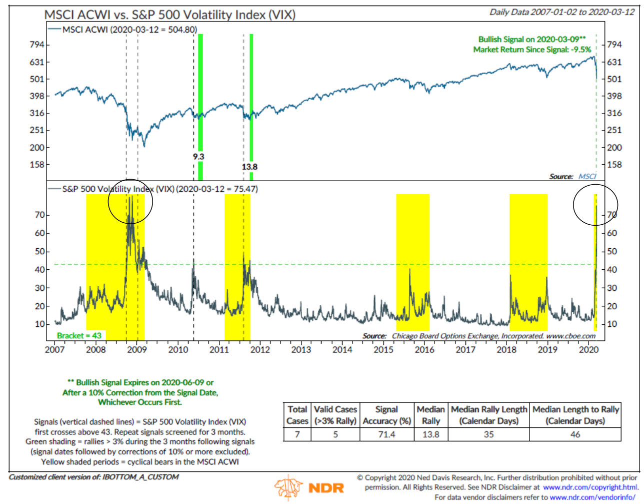
From that emotional perspective and the sharp decline we have seen, we conclude that a good short-term low is in the making. Put/call ratios have exploded to the highest level in almost 10 years. . However, a classic selling climax (sharply down, sharply up, closing up with large trading volume) was still lacking in last week's lows. Fear indicators like the VIX (chart 1, next page) usually show those extreme readings

BEFORE the final low arrives. In other words, the lower low in price that we still expect should show positive divergences with lower prices and lower VIX readings. We saw this in 2009, 2011/12, 2015/16 and in 2018 (January and December).

We recommended that investors go defensive and use stop loss procedures and hope that our advice helped against the sharp decline. If investors hold not enough cash, we would raise some on forthcoming bounces, until a bottom can be confirmed.

CHART 1

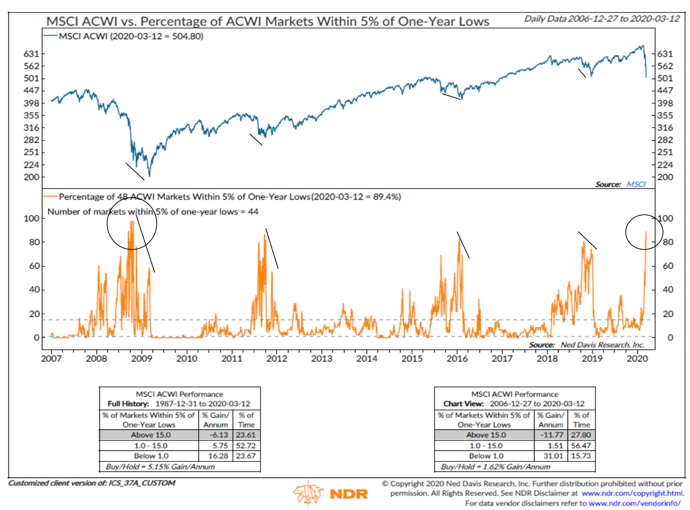
World Equity Index vs. Volatility Index (VIX)



Source: Ned Davis Research, Inc.

CHART 2

World Index vs. Markets within 5% of 1-year Lows



Source: Ned Davis Research, Inc.

There are many other indicators we follow that show the same extreme and lack of divergence. One of them is the percentage of world market indices within 5% of one-year lows (chart 2). As you can see, the spikes to the upside of the bottom clip indicator usually arrive before the final low, and its reading is lower than the spike when the final price low is reached. Based on our indicators, we conclude that we may be close to an important short-term low but not yet at an important medium-term low. We do not have high conviction that the final low is in, as the positive divergences we usually expect to see at important lows are still lacking. It is therefore safer to wait until we see a variety of different divergences before going either long or covering shorts. We recommended that investors go defensive and use stop loss procedures and hope that our advice helped against the sharp decline. If investors hold not enough cash, we would raise some on forthcoming bounces, until a bottom can be confirmed. Our analysis is similar for European markets and selected Asian markets, although Asia is now holding up better.

From an anecdotal evidence standpoint, most questions we have received from clients are whether it is now good to buy again. While we understand why people would ask this question, we rather focus clients on the fact that at solid lows, nobody is really interested to buy because the stomach pain at a solid low hurt so much. So, what do we make out of the situation? Read on.

The Fundamentals Stink

We differed from the consensus going into this financial crisis, as we have been expecting a slowing world economy for a while due to excessive inventories in many regions, particularly in Asia and Europe. They were also on the high side in the US, but not as excessive as in other regions. The US was the best-looking horse in the glue factory. While in certain semiconductors there were shortages, that is the exception confirming the rule. Moreover, semiconductor shortages are often present before the economy weakens, due to multiple ordering that later get cancelled and leads to gluts and weak pricing. The other main factor was the negative credit impulses we often pointed to. Thus, our view differed considerably from the consensus narrative. That is why we went into this with a cautious/bearish equities and bullish bonds attitude and were prepared when the cascading started. We always strive to be right on the overall direction of the trend, rather than be too precise in our forecasts and wrong on the overall markets.

On top of the slowing world economy, we are now faced with partial but serious shutdown of several large economies. Yes, China showed some signs of timid stabilization – but the rest of the world is in panic mode and not there yet. In addition, we are faced with an oil price war between Saudi Arabia and Russia. This leads to defaults in the US shale industry and has infected the credit markets. And the credit markets infect equity markets. If this crisis continues for a while longer, another domino may be the pension industry that is underfunded and unable to achieve the returns it needs to cover its liabilities. In other words, this is a multiple whammy that may trigger many dominos which could uncover structural problems that have been covered up by inflating financial assets in recent years. It could even happen that the repo crisis comes back with a vengeance, due to this sequence of events. When the tide goes out, it shows who swam naked. And we may be in for surprises. It is conceivable that once those problems are triggered, they cannot be fixed quickly because a certain process is set in motion that is difficult to stop. Nobody knows for sure, but we will find out.

If this crisis continues for a while longer, another domino may be the pension industry that is underfunded and unable to achieve the returns it needs to cover its liabilities.

China is step by step resuming its economic activities but operating still decisively below normal capacity usage. Europe is shutting down. As we see it, the Coronavirus went from Asia to Europe, and then from Europe as well as Asia to the Americas. This means that the shutdown of the American economy is only beginning now with a lag to Europe, where the shutdown continues. All of this is worse than a trade war, in our view. People are now fearful and do not go out, do not go to work, do not visit restaurants, sporting events, libraries, or museums. They have stopped travelling, and the transportation and leisure industries such as airlines, trains, buses, and cruises are hit badly. The same goes for hotels or the entertainment industry. Even Disneyworld has shut down! As far as we can remember, it is the first time in our virtually 50 years of investment activity that economies have been shut down as quickly and as harshly as this time. No one has any experience with what the exact damage will be, because there are no historical precedents. It is hard to forecast the economic impact here, given there is no data to base decision off.

Anecdotal evidence from checking with friends and colleagues in different regions of the world point to severe damages. Uncertainty will remain high until corporations report their Q1 earnings and explain their situations and what it means for their top and bottom lines. That will be in April/May 2020.

Chart 3 shows that world corporate earnings have gone sideways for the last 18 months. We wonder why investors bid stock prices up so much in view of this? Earnings are already below their historic growth trendlines. If we are right, earnings may weaken substantially over the next 2 quarters. Chart 4 shows where current consensus estimates are for Europe (top clip), and the US (bottom clip), compared to where the reported earnings currently are. This demonstrates that such estimates are worthless at turning points and are more misguiding than anything else.

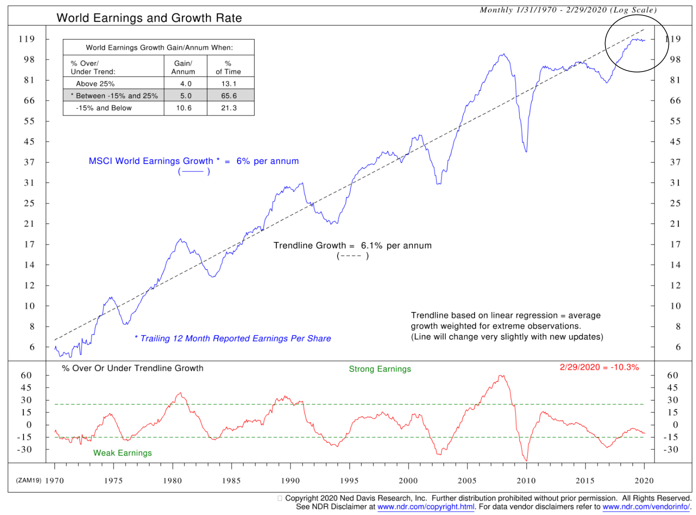
Of course, governments are offering financial help in different forms and to different degrees, but large in quantity. This is good and may save some companies by helping them to survive instead of going bust. And it should help the financial industries, like banking, which would otherwise suffer gigantic loan defaults because not all companies and individuals can be saved. However, there will be many casualties.

It is our assumption that the world economy is in recession and will remain so for the first half of this year if not longer. Fiscal stimuli usually take time (our experience is up to 6 months) until they begin to work. Moreover, they can only work in a positive way once people's fear declines and they go back to work, go out again, attend entertainment and professional, sporting and cultural events, and people begin to travel, visit restaurants and stay in hotels as they did before.

We assume that the virus will begin to disappear with warmer weather. We expect that the rise in new infected people will level off in from late April/May

CHART 3

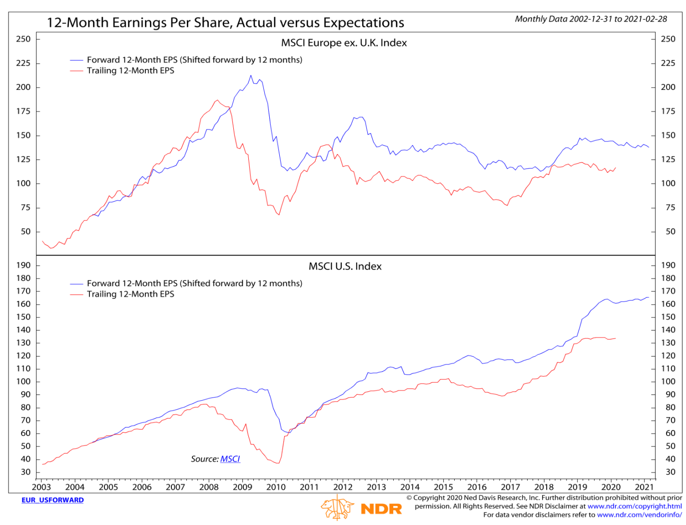
World Earnings & Growth Rate



Source: Ned Davis Research, Inc.

CHART 4

12 Month Earnings Per Share - Actual vs. Expectations



Source: Ned Davis Research, Inc.

onwards, and that by mid-year the hysteria will abate. However, the economic damage is done. It is conceivable that the economy will not recover as quickly as some presently believe. Keep in mind that the world economy has a serious structural problem that has prevented it from achieving the growth rates it enjoyed in the past, as we have often reported in our comments.

The key for the world, not only for the US, is whether the Fed supplies enough liquidity and whether the US banks are willing to channel part of it to the outside world.

The key for the world, not only for the US, is whether the Fed supplies enough liquidity and whether the US banks are willing to channel part of it to the outside world. Most experts do not understand how dependent the world has become on US dollar liquidity, particularly in Asia, Europe, and EM related countries. If the US banks can initiate another global credit boom, the world economy may recover beginning from the second half of 2020 and particularly during 2021. A weaker US dollar in the currency markets would signal this. However, if the US banks are unwilling to channel more liquidity via the interbank market to those other regions, the repo crisis may pop up again. Foreign banks are hungry for US dollars due to the large outstanding USD denominated debt, and its requirement to service it. A stronger US dollar – and this is what we eventually expect – would signal serious liquidity problems with the risk of bankruptcies and defaults in many parts of those regions. We are very concerned about the banking sectors in Europe and Asia. In Europe, we fear that there will be severe problems in some countries due to a deep recession that needs the help of other nations. And it remains to be seen whether the stronger countries (who are left?) are willing to pay in solidarity on behalf of others. In the past, they paid huge amounts for the sins of the past committed by others, but with the current environment this is not nearly as likely. It could result in a euro crisis eventually, and even in some dislocation or even disintegration in the EU and EMU itself – not just their currency.

We are very concerned about the banking sectors in Europe and Asia.

China may solve part of their problems internally, but China still depends on foreign funding. This may support the yuan for a while (when they exchange the USD for CNY), but the long-term effect may trap the Chinese system and make it more and more dependent on the US monetary policy. If they would supply funding via printing of money, their currency would decline sharply. The risk of high inflation in combination with a weak economy would hardly be the desired set-up for the 100-year anniversary of China's Communist Party in 2021.

The odds that this is a repeat of all the other buy the dip occasions are slim.

For these reasons, it is dangerous to believe this decline is an easy way to make money. Many investors are too young or too inexperienced to know that prices have not always risen after a decline. In our view, too many investors think we will see a repeat of what happened in late 2018 and 2019. The investment industry today is run by a generation who does not know anything else but buying the dip. They believe this is the way the system works. Our view differs. This is the way the system works… until it does not any longer. The exaggeration of this phenomenon is the passive investment craze, which simply is a buy and hold the market strategy. While we are not certain whether we have already arrived at that moment or not where we will see a structural change in how the investment world and markets function, our gut feeling tells us that we have.

Something is very wrong with our system and the way our authorities have managed and guided us for the last 25-30 years. It could therefore be the beginning of a lengthy cleansing process, in which market forces and intervention by authorities will be fighting a battle for years to come. It could lead to a disastrous decline, like in the great depression. Or it could lead to a multi-year period of huge swings in both directions, but a lot of pain for investors and very meager investment results. The odds that this is a repeat of all the other buy the dip occasions are slim, in our view. It therefore requires some scenario thinking and preparations for a new era about we have often written when touching on secular issues.

Tactics Trump Forecasting

Based on the above backdrop, we will operate with the following different scenarios for our analysis on making future moves. We do not know what the future holds, but the investment world is a game of probabilities, not certainties. Here are our three scenarios we are watching, with our odds on each:

A) Global economic crisis with a market meltdown like 1929 (20% odds):

It is not our working hypothesis, but in view of the highest leverage in the world economy and the extreme deflationary hit, we cannot overlook this risk. While the financial system is more elastic today than the rigid gold standard of the past, we cannot fully exclude a systemic accident as dominos begin to fall.

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Just think of all the hidden risks in the financial service/banking industry, its relatively low capitalization, the extreme global interlink that increases the risks of a global infection. The trade war and geopolitical disorder may prevent a cooperation as needed because there is a complete lack of trust between the major regions. Keep in mind that we have a major misconstruction in the currency market, with a euro that does not function properly and calls for bail-ins when things get ugly, thereby risking a run on banks. Moreover, the dependency on US funding is key to the global credit system and its survival. We doubt the Fed understands its full dimension.

B) This decline is terminating a cyclical bear market that started in early 2018 (30% odds):

It is conceivable that the market and many stocks really peaked in early 2018 and had a down-up-down correction. This is particularly true for European markets, as some may have even peaked in early 2015 and whereby this decline is the final washout. While the "up-sequence" led to minor new highs here and there, it was a fake high and not confirmed by the majority of stocks. For that reason, this decline is so vicious, as it should have happened a long time ago but was postponed due to the missing alternatives (negative rates) and optimistic sentiment brought by a rallying US stock market. The potential would exist that a new mini cycle begins again and leads major equity indices to new highs.

Some of the major company names in Europe are fighting for survival, and there will be a few major casualties of large, well-known companies, which is what one would see at a major low. Thus, we could see a major washout in the European markets because the European economy hardly grew before the Corona Virus hit. This scenario seems less plausible for the NASDAQ or the S&P, while one could make this case for other major US indices like the Value Line Composite, the New York Stock Index Composite or the Russell 2000. This scenario would perfectly fit the Asian markets, be it Hong Kong, Korea, Singapore or even China. It would suggest that new highs could follow in the next bull cycle.

C) Structural Multi-Year Bear Market with Wide Swings (50% odds):

This is our major working hypothesis at the present time (subject to change as current events unfold). The biggest take away is to not get married to a firm scenario, but rather to trade the swings as they develop and keep an open mind. The underlying process is a cleansing process of the excess in the system, and similar to scenario B, it will bring many battles between the free market forces and the interventions by authorities. There would be major high percentage moves in both directions. A buy and hold strategy would not only deliver disappointing results, it would also mean that an investor must endure huge swings and high risks for meager returns.

The biggest take away is to not get married to a firm scenario, but rather to trade the swings as they develop and keep an open mind.

The only strategy that may be able to deliver clearly above average returns will be market timing, which is currently not en vogue and some even consider it to be completely discredited. Active strategy should also work better than passive strategies, as in the difficult fundamental environment good companies would deliver considerably better results than bad companies. The best strategy to financially survive a multi-year structural bear market will be to combine active stock picking with a macro-timing overlay.

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The problem is that those who were trained at practicing this approach are dinosaurs in the industry, as they lived and worked through the period from the 1960s and 1970s and are mostly retired or passed away. The prop traders of the 1980s-2009 could also do it, but few exist anymore as most prop desks were closed after 2009. What remains are a few hedge funds, but even they have become much more quantitative and mean reversion oriented over the years.

The 20-year cycle in equities would point to 2022 for a major low, as 1942, 1962, 1982, 2002 were all major lows. Keep that in mind.

Our caveat is that we may be biased with this macro overlay and market timing strategy, because we started trading in 1968 at an age of 18 years old. We have lived through many bull and bear markets, and have been amazed how our industry has and continues to change.

While we historically have not made as much money on the upside as we should have, we made money in every major market downturn since 1973. We believe in the compounding and if we are right, the next few years will bring a new world and a new paradigm to investment management, for which the industry is not well prepared. The 20-year cycle in equities would point to 2022 for a major low, as 1942, 1962, 1982, 2002 were all major lows. Keep that in mind. In this scenario, the next medium-term advance will not lead to new highs for the vast majority of equity indices around the world, and certainly not for the majority of stocks.

Defining Tactics Is More Important Than Forecasting

There are similarities in all three scenarios – the first wave down in the waterfall decline (scenario A), the washout sell-off to terminate a cyclical bull from 2018 or 2015 (scenario B), as well as the big first wave down in the multi-year whipsaw market scenario (scenario C).

The most important thing for investors will be to enter on the long side only after the sharp decline. But ONLY when the odds are very much in your favor. In other words, do not try to catch a falling knife but buy a successful retest. One may say that you may then pay a higher price over the low. That is true, but those who thought they catch a low were either just very lucky, if they did catch the low, or very unlucky if they bought somewhere on the way down.

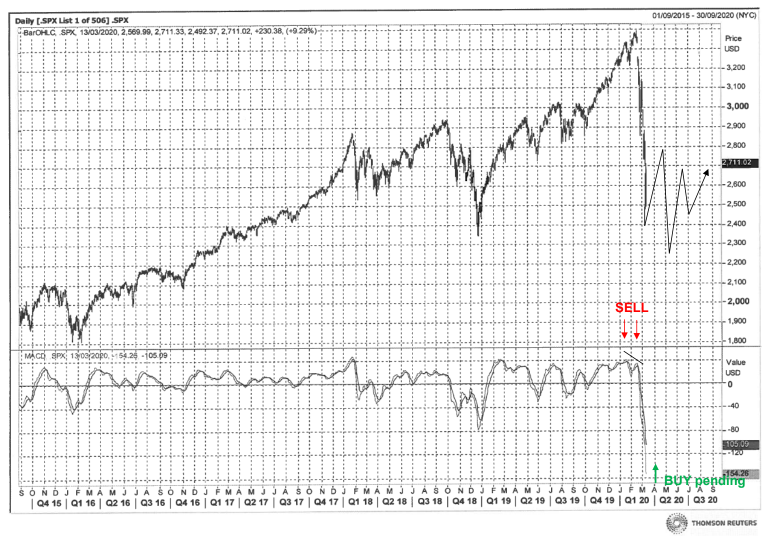
Our view is to wait for the internal low, which may have been Thursday of last week or early in this new week. Let us say it was Thursday – or any day in the future with the worst trading statistics (down volume, declining stocks, number of new 52-week lows, etc.). The market will try to recover, and the recovery bounce may be impressive. They always are and the momentum, breadth and volume thrusts are often more impressive than during bull markets. Friday of last week, however, did not show impressive statistics at the close.

As we believe the fundamentals will remain rotten well into mid-year, there will be bad news again and the market will fall back again after a first bounce. Then it will test the former lows, which means it will either get there or slightly above or slightly below those previous lows. If the internal statistics are then better, which means less powerful on the downside, it is a good sign. In that case we would buy when the next short-term buy signal from our momentum work kicks in. This is a timeweighted oscillator that we have been using since the 1970s. But it could also be a MACD or any other time-tested oscillator investors/ traders feel comfortable with.

If the market makes its internal low in March, which we anticipate it will (most likely in these days), a recovery bounce into April would follow (chart 5). Such bounces usually last between 2-3 weeks based on our experience and historical indicators and are front loaded. This would bring us into about mid-April. From early April onwards, companies begin to report their Q1 results and many will not be pleasant, and the forecasts will most likely be foggy at best if not outright bearish.

CHART 5

S&P500 Daily & MACD



Source: Thomson Reuters

Thus, the market will most likely sell off again and try to test the former low, which will bring us into mid-May. If the market cannot hold the low and breaks through to decisive new lows with worse statistics than a previous extreme, the whole procedure begins anew. And we would only buy if the former lows would be tested successfully (with better internal statistics) and a short-term buy signal by our oscillators would kick in. If May would be the ultimate low with all the right characteristics, we would buy at least 50% of what we want to be long in the stocks for a medium-term trade (at least 3-6 months) we like for investments. Keep in mind that the weekly momentum indicators are not even close to a buy point yet if you compare the current situation to December 2018 (chart 6, next page). That is why there is no need to rush in on the long side.

Our view remains that from July 2020 on, markets should trade higher.

We often point to the 40-week cycle low, which is due for July. If the markets bounced from a May low, it would bounce into June and correct into July. That would be the final easy buy and if the statistics would again be better than before, we would buy the final percentages of stocks we like.

Our view remains that from July 2020 on, markets should trade higher. The medium-term indicators at that time should all flash bottom indications. By July, the Corona virus will hopefully be on summer vacation (and if we are lucky, some smart scientists will come up with an anti-viral treatment). Look out for when Tom Hanks, the celebrity actor, releases the news that he and his wife are healthy again. That would be a very positive sign for the market, as the public around the world will read and see that they are healed after a few weeks. Hopefully, it will instill confidence and stop people from panicking.

As we move further into later this year, all the negatives may then turn into a positive on a rate of change basis. The depth of the Corona crisis would be behind us and markets would deal with other problems. Our view remains that the second half will show a better performance, particularly Q4. But we don't want to waste firing power by buying too early and in too risky a situation. Therefore, we have laid out how we intend to proceed for the benefit of our subscribers.

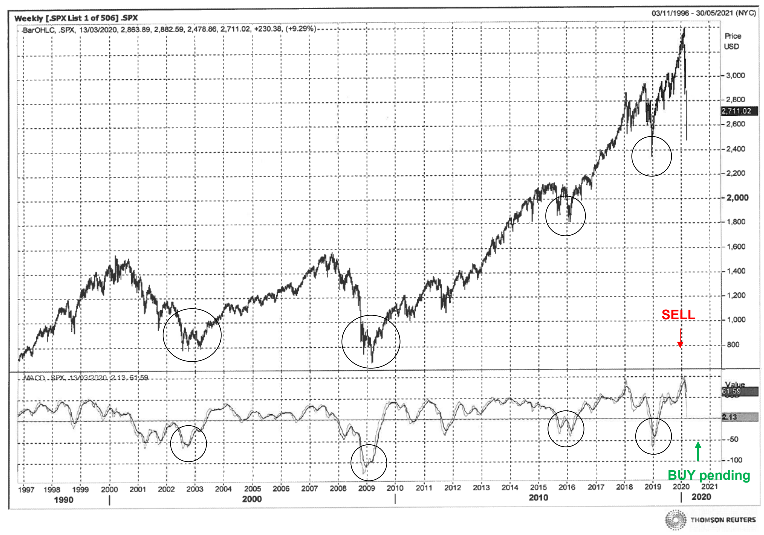
Bonds Trade Juxta Positioned to Equities

Many call the spike down in bond yields as the final low. It could be, but we are not prepared to act on it yet. It could very well be that the Fed must push the yield for Treasury bonds towards zero to make it unattractive for investors and to force them to buy and support the corporate bond market. The rate cut on Sunday and the announcement to buy large amounts of Treasuries are already pointing in that direction.

It would mean that we have seen a spike low in yields,

CHART 6

S&P500 Weekly & MACD



Source: Thomson Reuters

followed by a short-term correction. However, during the retest of the equity market low, Treasury yields could dive again and even make a new low. We would not bet our money on the new low. However, if equities retest successfully and we would become a buyer, we will also in all likelihood become a seller of bonds. The supply of bonds will be huge, as all governments fall into deficits because on top of declining revenues due to the weak economy, their spending would increase. We doubt inflation would rise in this scenario but that is not the point. The market will at some point question the credibility of our governments and ask for higher risk premiums, or higher real yields.

The technicals are setting up for a potential positive divergence between the indicators and the yields (chart 7, next page). Prepare yourself and be ready to act in coming 3-4 months.

We had been looking for a major low during the first half of this year, and we think markets are close. Quality spreads among sovereigns are already widening sharply and we would therefore already sell the weak borrowers among industrialized nations like Italy, Spain, Portugal, Greece, etc.

We would still stay away from EM debt, particularly those with very weak currencies like Turkey, Brazil and South Africa, just to name a few.

Our bottom line is to prepare to sell your bond holdings or shorten maturity.

Our bottom line is to prepare to sell your bond holdings or shorten maturity. Some may ask what to do with the money, particularly Europeans with negative rates. In that case, we would suggest keeping the bonds but sell bond futures against it, or a multiple of your longs. This way you may escape the negative rates and make more on your short bond futures than what you lose on you longs. That is our intended strategy. We assume that all the fiscal stimuli that will arrive later this year and well into next, will have at least a temporary positive effect on the economy and will push yields higher.

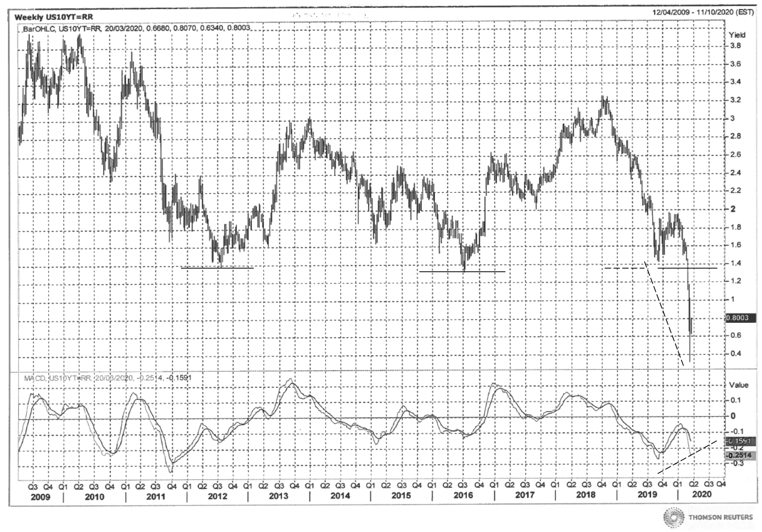
US Dollar Whipsaws but Giving Way to a Rising Trend

The consensus is very bearish on the US dollar because the line of argument is that the US Fed will ease money and that will weaken the US dollar. In contrast, we weigh the underlying demand for US dollars much higher. The repo crisis is nothing else but an overwhelming demand of the worldwide banking system (and their lending clients) for US dollars, which the US banking system and the Fed respectively must supply.

If the Fed fails to understand that important international dimension, and guides policy primarily based on US perspectives, there may be a shortage of US dollars. Moreover, if the US banking system turns more cautious because of the weakening US

CHART 7

10-Year US T-Bond Yield Weekly & MACD



Source: Thomson Reuters

and world economy – which is the normal behavior – it would fail to channel the USD liquidity via the interbank market into other regions as needed. This would force foreign borrowers to buy more US dollars in the market. Swap lines between the Fed and a few foreign central banks may reduce the pressure but not eliminate it.

While we agree that the US Fed is easing, it may not be enough.

While we agree that the US Fed is easing, it may not be enough. Moreover, we think that Asia and Europe are less safe regions in times of turmoil, and capital feels safer in the US. For this reason, we expect the US dollar to trend firmer over time.

In the short-term, the euro has bounced from 1.08 to 1.14. That was most likely part one of a three stage countertrend move up-down-up. It has already retraced half of this bounce. We see the upside limited to 1.16-1.18 at most as the downtrend line will offer heavy resistance. And after this bounce attempts, we expect the euro to fall to new lows, as the weakening European economy may trigger a crisis in the eurozone that we expect to impact the banking system and the currency. We admit that we are less certain about the Japanese yen and the Swiss franc (which is guided toward the euro by the Swiss National Bank).

Outside these major currencies, the US dollar trends firmer against the EM universe. We mentioned many times that the biggest risk in the cycle is where the biggest credit excesses took place and in the current cycle that is the EM universe. We remain bearish the EM universe including the currencies. We mentioned in one of our recent reports in particular the Turkish lira, the Brazilian real and the South African rand as particularly vulnerable. But in general, we see EM currencies and Asian currencies (except perhaps the yen) on a weakening trend against the US dollar. The USD Index (heavily weighted towards the European currencies) has had a decisive bullish reversal last week. It does not even show how strong the US dollar in the forex arena really is. But we expect eventually a breakout topside (chart 8) and above 100 and perhaps even a new high for the cycle.

Pound sterling is going through the expected correction against the US dollar, which is likely not complete and may last a few more months. While the corona virus may help the UK to achieve a better deal than would otherwise be possible – because the EU cannot be as harsh in a weak economic environment – we still should not underestimate the dogmatic EU bargainers. Our view stands that these discussions will be extremely difficult.

Do Not Bottom Fish Oil

When Russia walked away from the table and a deal to cut production, Putin was probably targeting the US shale oil industry. He is hardly interested to kill it because it would mean that the big companies would collect what remains at bargain prices and he would

CHART 8

US Dollar Index Weekly & MACD

Source: Thomson Reuters

have to deal with them in the future. He simply wanted revenge for the stupid sanctions that the Democrats forced Trump to impose. Trump was right to become friendly with Russia to have a partner he could use to play China, while the "deep State fraction" of Congress still live in the cold war era. The Democrats simply wanted Trump to sanction Russia because they suppose Russia helped him to beat Hilary Clinton. Their partisan behavior may ultimately come back to bite them.

> The price of oil may go even lower, despite the US restocking its reserves at a cheap price. It could fall to the low $20s until the bottom is reached.

Saudi Arabia wants to punish Russia for walking away from a deal. But Russia can hold out longer than Saudi Arabia, since the kingdom has its currency pegged to the US dollar and needs at least $60 oil (some say $80) to balance its budget. We suspect Prince MBS knew what he was doing, since he proactively removed some contenders in his family for the king position to avoid the risk of getting toppled in a time of crisis for the nation's finances.

At present, global demand probably declined by 2-3 million barrels per day while Saudi Arabia has increased its supply to 12.3 million barrels, which is beyond its maximum. It will hardly do so for long, as the price on its government finances is tremendous. We expect a normalization of the situation in the second half of the year. Until then, the price of oil may go even lower, despite the US restocking its reserves at a cheap price, as Trump decided. We have been expecting a temporary undershooting of our $45-$65 trading range for WTI crude oil. It could fall to the low $20s until the bottom is reached.

Gold Was A Trap

Whenever the price of gold flies higher, my mailbox gets inundated with a high number of "this is the beginning of the big advance" by the goldbugs. We also like gold long-term because we see no other option than our monetary authorities debasing paper currencies to prevent a systemic collapse, this will eventually be expressed in a higher price for gold.

But many of the believers in gold misunderstand that our system is a "FIAT" currency system that offers much more flexibility for authorities to bail the system out again and again. That was not the case with the gold standard of the 1930s. But unlike in the 1930s, gold is a free market asset that has already priced in today's market knowledge, unlike in the 1930s when several nations including the US had to officially devalue their currencies against gold and its price rose to that higher fixed level. When a deflationary force hits our system, it is usually bearish gold. Only the inflationary response is bullish – in theory at least. In practice, inflationary and deflationary forces do not always show up immediately as many analysts and investors want to make us believe. The ebb and flow in the gold market is not always as clear as "theory"

CHART 9

Gold Weekly & MACD

Source: Thomson Reuters

would dictate.

We have been bullish the rally in gold but became hesitant as gold entered our target zone. We were concerned it could top out and begin a lengthy correction. Our reading of the gold market – and applying technical analysis, too – is that this correction in gold has begun. We have hinted at that risk several times in past reports. Now the weekly MACD and many other momentum indicators have signaled a correction. Moreover, the signal was given at a lower level than the last signal while the price of gold hit a higher level (chart 9). This is an important negative divergence, that in our view will lead to a lengthy correction. In addition, we dislike the fact that large speculators had increased their long positions to the highest level in years (chart 10, black line, next page). Our downside risk remains the low $1,400 area. The selling in the gold mining sector late last week was brutal. We recommended a stop loss at $1,610 and those price moves show you why one should use them. Our subscribers should be out of trading positions (if you have a very long-term view, and don't mind seeing the downside action – it may be ok to hold). We will keep you up to date with our view and how it may change.

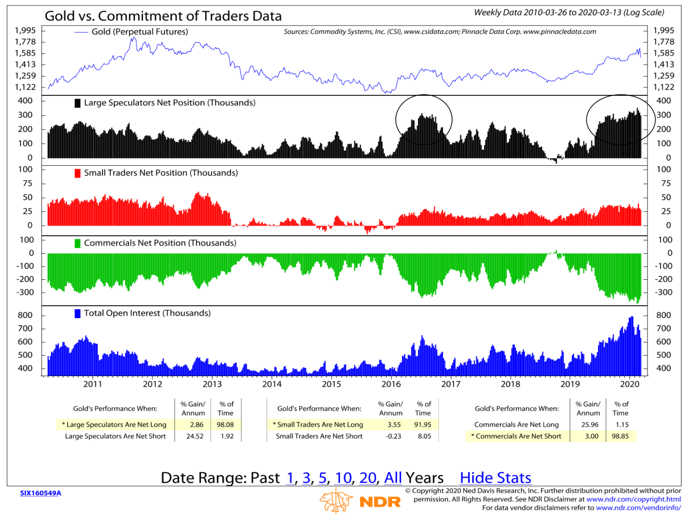
As always, please feel free to reach out to us at info@felixzulauf.

com or contact your sales rep with any additional questions. We will be sending out a registration link soon (hopefully Tuesday or Wednesday at the latest). In the meantime, please save-the-date for March 25th at 10:00 a.m. EST. Stay tuned! And most importantly, stay healthy.

Felix W. Zulauf
March 16, 2020

CHART 10

Gold vs. Commitment of Traders



Source: Ned Davis Research, Inc.